CHAPTER 11
INDONESIA

Introduction. President Wahid's departure and President Megawati's arrival raises high expectations of better economic performance.

- Megawati has a sensible budget and an economic strategy that would normally establish the foundation for a durable economic recovery.
- Unfortunately, these are not normal times.

Negative Global Setting. The world is moving towards a global recession—or at least a severe downturn. The 9-11 terrorist attacks in the United States:

- Shattered the assumptions of Megawati's economic strategy,
- Stirred up anti-U.S. feelings toward U.S. business interests in Indonesia, and
- Worsened global demand for Indonesian exports, thereby hammering Indonesian growth prospects.

Crisis Management. Given this negative setting, Megawati's best approach is to:

- Lower political expectations of any early economic recovery and
- Limit the damage to the already struggling Indonesian economy.

The Wahid Days

Turnaround. In many ways, Indonesia is still digging itself out from the Asian economic crisis. The country suffered through a deep recession in 1998.

- The economy bottomed out in 1999.
- Under Wahid, GDP finally managed to grow in 2000, though only at a 4.8% clip—hardly enough to make up for the ground lost since 1997.[1]
- The 4.8% growth in 2000 was also a far cry from the bounce-back that Indonesia's neighbors enjoyed in 2000.
- At first, a spurt of consumer spending helped to boost growth in 2000.
- In contrast to most other Asian countries, Jakarta found higher oil prices (peaking at about $35 a barrel in 2000) a godsend for Indonesian exports.[2]

Figure 11-A. Selected Historical Data

$ Billions (or %)	'97	'98	'99	'00
Gross National Income	221.5	138.5	119.5	153.3
Purchasing Power	679	568.3	505.0	642.0
Real Growth (%)	4.5	-13.1	0.8	4.8
Inflation (%)	6.2	58	20.7	..
Exports	53.4	48.8	48.7	62.1
To U.S.	9.8	10.0	10.2	11.1
Imports	41.7	27.3	24.0	33.5
From U.S.	4.5	2.3	1.9	2.5
FDI from U.S.	7.4	6.9	10.5	11.6
In U.S.	0.3	0.3	0.2	0.2
Cur Account /GDP %	-2.2	4.2	4.1	5.2
Fiscal Balance /GDP %	0.0	-3.7	-2.3	-4.8
External Debt /GDP %	52.9	120.4	82.7	72.0

Sources: IMF, ADB, World Bank, U.S. Commerce

Figure 11-B

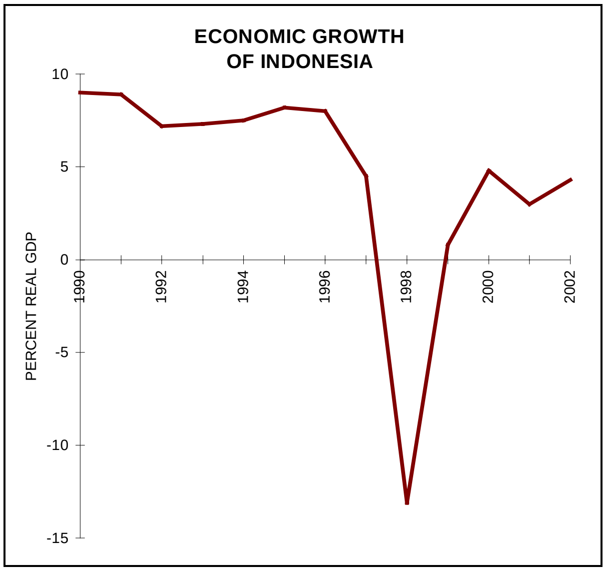


Figure 11-C

Exports Boom. Thankfully, exports remained solid throughout 2000 and were the main driver of economic growth. (See Figure 11-C.)

- In the first nine months of 2000, non-oil exports were up $10.7B more than in the same period in 1999.
- The weaker rupiah made exports more competitive and boosted the trade surplus.

Growth Not Durable. Unfortunately, the 4.8% economic growth spurt Indonesia enjoyed in 2000 was not sustainable.

- Economic growth in 1Q01 was 2.6%.
- IMF's estimate for 2001 is 3.0%.
- This is much lower than the 7% needed to curb unemployment.

Factors Behind Slowdown. The following factors undermined recovery:

- The U.S. slowdown weakened the U.S. appetite for Indonesian exports.
- Asian regional demand fell.
- Non-oil exports fell.
- The financial windfall from high oil prices—that drove growth in 2000—disappeared. Oil prices fell to $21 a barrel in 2001.[3]
- Stocks lost more than 30% of value during the Wahid era. (See Figure 11-D.)
- Wahid showed no knowledge or interest in a coherent economic strategy.

Figure 11-D

- East Timor violence sapped investor confidence, triggering capital flight.
- Foreign investors decided to stay on the sidelines until the dust settles.

Investor Warnings. Foreign investor concerns about the instability deterred the very capital inflows needed to revive investment and finance the government's large fiscal deficit.

- Both Moody's and Standard and Poor's (S&P) credit-rating agencies issued negative warnings about the country's future in early March 2001.
- Jittery investors also saw economic alarm bells. These included:
  - An over-borrowed fiscal situation.
  - High short-term interest rates.
  - A weak rupiah.

Dangerously Over-borrowed. By any realistic financial yardstick, the Indonesian government is dangerously over-borrowed.

- Indonesia's budget deficit is on track to reach a financially unstable 6% of GDP.[4]
- Indonesia's public sector debt is on track to reach a financially unstable 90% of GDP.[5]

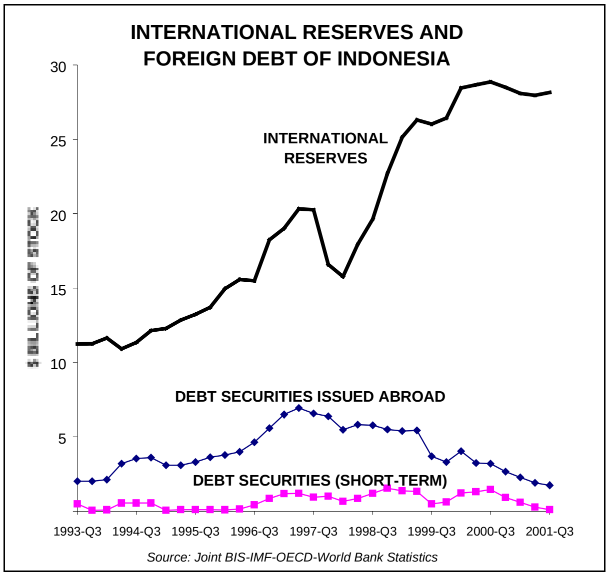
Higher Interest Rates. The over-borrowing also hammered short-term interest rates.

- When the government first forecast a budget deficit in 2001 equivalent to 3.7% of GDP, it was expecting its benchmark one-month interest rate to average 11.5%.
- Before long, a ballooning budget deficit on track to reach 4.8% of GDP pushed short term interest rates to 15.5%—or more than 4% higher than the government forecast.

Painfully Weak Rupiah. Without economic leadership at the top, the rupiah steadily weakened under the chaotic 21-month government of Mr Wahid.

- The rupiah fell from about Rp7,500 to the dollar when Mr Wahid took office to more than Rp11,000 to the dollar when Wahid left office.
- That was the lowest level in 20 months.
- The weak rupiah increased the burden of:
  - Re-paying a huge U.S. dollar denominated foreign debt,
  - Financing the high budget deficit,[6] and
  - Replenishing foreign reserves.

Figure 11-E



Fear of Default. As a result, S&P said Indonesia risked sovereign default (on government debt).

- IMF asked Jakarta to sharply reduce the budget deficit and heavy public indebtedness.
- On 21 May 2001, S&P downgraded Indonesia's long-term sovereign credit rating from B- to CCC+, putting the country on an embarrassing par with Russia, Pakistan and Ecuador.

IMF Suspends Disbursement. Jakarta's careless economic behavior in the Wahid era antagonized IMF keepers of the purse strings.

- In Dec. 2000, IMF did the unthinkable: cut the cash cow to Indonesia. Wahid failed to get $400M disbursement from the IMF's $5B credit line.
- Why did IMF play "tough love" with President Wahid? IMF suspended its funds in December 2000 because President Wahid failed to deliver key banking and corporate restructuring reforms. Two other multilateral bodies, the World Bank and the Asian Development Bank, were already giving Indonesia much less help in 2001.

Other Donors: Wait and See. Indonesia's troubles with IMF poisoned its financial credibility with other donors such as the Paris Club of official creditors.

- The Paris Club had rolled over $5.8B in debts that Indonesia was due to repay in 2000 and 2001.
- The Consultative Group on Indonesia (CGI)—a group of 30 donor countries that co-ordinates aid from foreign donors—voiced fears over Indonesia's budget deficit in April 2001.

The Megawati Days

Positive Response. Wahid's departure reduced political instability and financial markets reacted positively.

- On 30 July S&P upgraded its credit rating for Indonesia in a vote of confidence for new president Megawati.
- ING Barings advised investors on 16 August to re-enter undervalued markets such as Indonesia.
- The rupiah hit a four-month high on 24 July.[7]
- On 15 August, the Indonesian rupiah reached an 11-month high amid optimism over the new cabinet.
- Since Megawati arrived on 23 July, the currency has surged 30%.
- Similarly, the Jakarta Stock Exchange was nearly 40% higher in July than during its lows in April.

Good Start. Megawati has moved decisively to stop the rot. How? She:

- Installed a top economic team.
- Negotiated a long-awaited deal with the IMF.
- Unveiled a fiscally conservative budget.
- Demonstrated refreshing candor about the daunting economic woes in State of the Union address on 16 August. She highlighted the mountain of debt.
- Megawati also warned of a weak national legal system. [8]

Megawati's Budget. Her new budget correctly attempts to rein in an alarming budget deficit and national debt through painful economic reforms.

- The budget seeks to reduce the deficit from nearly 3.7% of GDP in 2001 to 2.5% of GDP in 2002.

- How? Two ways: Slashing subsidies and selling assets.

Cutting Food Subsidies. A key part of the government's commitments under its IMF-backed reform package is an agreement to cut subsidies in its bloated budgets.

- After years of procrastination, the government has promised to raise politically sensitive energy prices.
- Subsidies on fuel in Indonesia make up more than 30% of the budget, but only the upper and middle classes benefit from the subsidies.
- Nevertheless, Jakarta had to tread carefully with a plan to raise fuel prices by 30% to avoid widespread social unrest.
- Jakarta plans to sell $66B in assets held by the national bank restructuring agency.

Money from IMF? Yes. Megawati's candid diagnosis and prescription impressed IMF.

- This set the stage for new talks with the IMF in late August 2001.
- IMF ultimately released a $400M loan disbursement that had been suspended in 2000 as part of a $9.4B loan program.

Money from Paris Club? Yes. The release of IMF loans also cleared the way for approval from the Paris Club and the CGI, a group of international donors.

- In late September the Paris Club backed the second phase of a two-year debt-rescheduling deal with Indonesia.
- The debt-relief accord paves the way for formal clearance of the second stage of a $5.8B debt accord struck in April 2000.
- The $5.8B package covered public debt that Indonesia needed to pay back between April 2000 and March 2002.

Turns on Growth. Whether or not Jakarta can meet IMF and donor goals depends first on whether or not Indonesia manages to generate 5% growth.

- Even before 9-11, this 5% projected growth target for 2002 appeared too rosy.
- Why? Lower growth reflects the gloom surrounding the U.S. and Japanese economies.

Mission Impossible? The tough love camp at IMF may be correct that Indonesia's economic ship of state may no longer be rudderless with Megawati at the helm. But the seas have suddenly become a lot stormier. Now Megawatt's goals appear like mission impossible. Why?

Impact of 9-11

Terrorism against the United States is arguably tipping the United States' economy into a full-blown recession.

Weak External Demand*.* Given this grim external economic reality, it becomes next to impossible for the Indonesian economy to meet the targets outlined by Megawati in her first budget on 7 September. Among those targets were:

- Shrinking the fiscal deficit to just 2.5% of GDP in 2002 from a targeted 3.7% this year and
- Retiring more than $9B worth of debt.

Assumptions Too Rosy*.* In addition, economic volatility will put pressure on two other key assumptions that underpin the budget:

- An average exchange rate of 8,500 rupiah to the dollar and
- A benchmark interest rate of 14%.

Impact of Terror Attack on U.S. The terrorist attack on the U.S. has understandably made the assumptions underpinning the budget look unrealistic.

- On September 17, the rupiah closed at 9,340 to the dollar.
- The interest rate is currently running at 17.5%.

Rising Inflation*.* The weaker rupiah also aggravated Jakarta's struggle to curb inflation.

- In September 2001, the consumer price index was up 13% from a year earlier.
- This spike up is a far cry from the official inflation target for this year, which was 9.3% and 8.00% for 2002.

Stocks Falling*.* The 9-11 terrorism also caused Indonesian stocks to fall to a 14-month low of 395.

- Since the attacks, it has lost more than 10%, making it cheaper than some of its Asian peers.

Sell-offs Less Likely. Indonesia's plans to step up asset sales and privatization of state-owned enterprises are also less likely now.

- Gathering the necessary political consensus to push through important deals like the continuing sale of 51% of Bank Central Asia will be that much harder as long as the stock market remains depressed.

Threat to Exports. The terrorist attacks will also worsen Indonesian exports already sluggish prior to 9-11.

- A large part of the worry comes from outside the country.
- Though Indonesia is not as dependent on electronics exports as neighboring Malaysia and Singapore, non-oil exports are worth about $50B a year—more than a third of the country's GDP.
- And more than half of all Indonesian exports go to just three countries, all of which are struggling—Japan, the U.S. and Singapore.

Threats to Business.

- Offshore sales of Indonesian textile & shoe manufacturers may well dip 20%.
- The textile industry—which accounted for 13% of exports last year—is already suffering as orders dry up and goods remain stranded at U.S. ports.
- The Indonesian Textile Association said the sector would fall 20% short of its $8.2B export target this year.

Conclusion

President Wahid's departure and President Megawati's arrival raises high expectations of better economic performance. Unfortunately, Indonesia's economic problems are daunting. For instance, the country has a mountain of bad debt.

But Megawati has been candid in her economic diagnosis and generally on the mark with her economic prescriptions. She has also formulated a sensible budget and an economic strategy that would normally establish the foundation for a durable economic recovery.

Unfortunately, these are not normal times. Even if President Megawati makes a heroic effort to implement another impressive blueprint for economic reform, the external economic environment is particularly negative at this time.

The U.S. appetite for Indonesian exports was already weak prior to the 9-11 terror attacks in the U.S. The 9-11 attacks have deepened the U.S. recession and hammered Indonesian exports and prospects for growth.

Given this negative economic setting, Megawati's best approach is to lower expectations of any early recovery and limit the damage to the embattled Indonesian economy.

Endnotes

1 Even if Indonesia could sustain growth of 4% a year, it would take until 2005 for it to return to per-capita income levels prior to the Asian economic crisis.
2 Every $1 increase in the per barrel price of oil adds $100M to $150M a year to government revenues.
3 Oil prices will remain low if the world goes into global recession and the war on terrorism is short. But a more likely scenario, an escalated war on terrorism, will lead to smaller supplies of oil and therefore higher prices.
4 A budget deficit over 3% of GDP is financially unstable according to the Maastricht criteria.
5 Similarly, a public sector debt of over 60% of GDP is financially unstable according to the same Maastricht criteria.
6 Earlier we mentioned the fact that the weaker rupiah was actually helpful to boosting Indonesian exports. But on balance, a weak rupiah hurts Indonesia because its over-borrowed situation outweighs the export benefits it receives from a weak rupiah.
7 The Indonesian rupiah reached 9,800 against the dollar compared with more than 11,000 before the vote on 23 July by the 700-seat MPR (People's Consultative Assembly) to replace Mr Wahid.
8 The bedrock for any economic transformation is therefore a rule of law and sound institutions. Unfortunately, standing up a stable legal system will take decades.